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No. 88-1789

In the Supreme Court of the United States

OCTOBER TERM, 1989

H. J. FREEDE AND JOSEPHINE W. FREEDE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a payment received by petitioners under a "take or pay" gas purchase contract for gas not taken was excludable from their gross income as a production payment within the meaning of Section 636(a) of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is reported at 864 F.2d 671. The opinion of the Tax Court (Pet. App. 18a-45a) is reported at 86 T.C. 340.

JURISDICTION

The judgment of the court of appeals was entered on November 1, 1988. A petition for rehearing was denied on January 27, 1989 (Pet. App. 16a-17a). The petition for a writ of certiorari was filed on April 27, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner H. J. Freede[1] owns fractional working interests in various oil and gas leases. In 1975, he entered into a contract to sell gas from one of those leases to Oklahoma Gas & Electric Company (OG&E). The contract included a "take or pay" provision that required OG&E to pay for a specified minimum quantity of gas each year, regardless of whether it took physical delivery of the gas. If the amount of gas paid for under the "take or pay" provision exceeded the amount actually taken, OG&E had the right to credit the excess amount against gas taken in excess of the minimum contract quantity for some future year. This right to a credit against gas purchased in excess of the minimum contract quantities in future years was the only way to recoup payments for gas not taken. If such payments were not recouped during the 20-year term of the contract, OG&E would never receive any gas in return for the excess payments, or any refund. Pet. App. 3a, 20a-22a.

In 1979, OG&E made the minimum payment required by the contract, but took less than the minimum contract quantity. OG&E paid petitioner H. J. Freede a total amount of $462,881 in 1979; most of that amount ($343,255) was paid because of the contractual requirement and represented an advance payment for gas not actually taken in that year. The amount of gas paid for but not taken was available to be credited against gas taken in future years. Pet. App. 3a-4a, 23a-24a.

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[1] Petitioner Josephine W. Freede is a party solely by virtue of having filed a joint income tax return with her husband for the year in issue (Pet. App. 2a & n.1). This case was consolidated in the Tax Court and in the court of appeals with a case involving the income tax liability of Roger S. Folsom and Mary M. Folsom, who also received payments under a "take or pay" contract for gas not taken. The Folsoms did not file a petition for a writ of certiorari.

On their 1979 income tax return, petitioners did not report as income the $343,255 received for gas not taken (Pet. App. 4a, 24a). They took the position that the excess payment created a "production payment" in this amount in favor of OG&E. A "production payment" is a right to a specified share of production for a limited time from a specified mineral property, when production occurs. Under Section 636(a) of the Internal Revenue Code,[2] a production payment carved out of mineral property is treated for tax purposes as if it were a mortgage loan on the property. Petitioners contended that the excess payment therefore should be treated as a loan to them from OG&E, with income recognized only when the gas is actually delivered in subsequent years. The Commissioner determined, however, that the excess payment did not create a production payment within the meaning of Section 636 because OG&E had no economic interest in the gas in place; he therefore concluded that petitioners were required to include the full $462,881 received from OG&E in 1979 in their income for that year.

2. Petitioners sought redetermination of the resulting deficiency in the Tax Court, which ruled in their favor in an 11-4 reviewed decision (Pet. App. 18a-36a). The majority concluded (*id.* at 28a-34a) that all of the criteria set forth in Treas. Reg. § 1.636-3(a)(1) (*reprinted at* Pet. App. 26a) for determining when an arrangement is a "production payment" within the meaning of Section 636(a) were satisfied here. The principal disagreement between the parties concerned one of the criteria—whether OG&E's right to apply the excess payment to future gas purchases was "an economic interest in [the] mineral in place"

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[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for 1979, the taxable year in issue.

(Treas. Reg. § 1.636-3(a)(1)). The majority found that OG&E's interest in the gas "rises to the level of an economic interest, due to the contractual rights and obligations of OG & E" (Pet. App. 32a). The majority relied on the contractual provision that gave OG&E the right to require the producer to maintain certain production levels, stating that the contract therefore gave OG&E "both rights to the minerals in place and a means of controlling production" (*ibid.*).

Four judges dissented in three separate opinions. Judge Nims, in an opinion joined by all the dissenters (Pet. App. 37a-41a), stated that OG&E did not acquire by investment a depletable interest in the mineral in place. Instead, he concluded that OG&E was "simply buying petitioners' gas at the wellhead, not mineral in place" (*id.* at 39a). Judge Williams, in an opinion also joined by all the dissenters (*id.* at 42a-45a), explained that OG&E did not have the requisite economic interest because it "has no legal right to the mineral in the ground" and it "is not seeking a return from extracting the gas" (*id.* at 43a, 45a). He pointed out that OG&E had the right to reject delivered gas that did not meet certain quality specifications and that the price it paid for the gas was determined by the market price after extraction (*id.* at 43a-45a). Thus, he stated that the "take or pay" contract was "nothing more than a long term supply contract that gives OG & E some assurance that a relatively stable source of natural gas can be delivered to its pipeline according to its specifications when its needs dictate" (*id.* at 45a). Judge Parr, in an opinion joined by Judge Nims (*id.* at 41a-42a), expressed her concern that the majority had "elevat[ed] a prepaid contractual right to a supply of a mineral to the level of an investment in the mineral in place," which would "open the door to the possible distortion of the tax consequences of all transactions involving natural resources" (*ibid.*).

3. The court of appeals reversed (Pet. App. 1a-16a). Citing *Palmer* v. *Bender,* 287 U.S. 551 (1933), the court observed that an interest in minerals constitutes an economic interest that can give rise to treatment under Section 636 if a two-pronged test is met: "(1) there must be an interest, acquired by capital investment, in the minerals in place; and (2) the return on the investment must be realized solely from the extraction of the minerals" (Pet. App. 6a-7a). The court declined to decide whether the first prong of the economic interest test was met, finding that an analysis of several relevant factors led to no clear conclusion (*id.* at 7a-13a). The court rested its decision on the second prong of the test, concluding that OG&E did not look to income derived solely from extraction of the gas for the return of its investment (*id.* at 13a-16a). The court stated that OG&E was "not an investor seeking profit from gas extraction," because its "profit is derived solely from the remarketing of the gas to its customers downstream from production, and not from production itself" (*id.* at 15a). In other words, "OG&E's interest is merely that of a consumer paying for gas it receives at the wellhead, not an investor looking for profit from successful extraction" (*id.* at 13a). Having concluded that OG&E did not have an economic interest in the mineral in place, the court held that the excess payment did not create a production payment and therefore was includable in petitioners' gross income (*id.* at 16a).

ARGUMENT

The court of appeals correctly held that OG&E's excess payment under its "take or pay" contract did not create a production payment within the meaning of Section 636 of the Code. That decision is fully consistent with the decisions of this Court, and it does not conflict with any deci-

sion of another court of appeals. Indeed, petitioners candidly acknowledge (Pet. 16) that the question presented here is one of first impression. Accordingly, there is no reason for review by this Court.

1. Petitioners do not dispute that the court of appeals applied the correct legal framework in determining whether the excess payment that they received from OG&E created a "production payment" covered by Section 636. Specifically, petitioners agree that, in order to constitute a production payment, OG&E's right to future production must be an "economic interest" in the mineral in place (see Pet. App. 4a-5a).[3] Petitioners also agree that the inquiry into the existence of an economic interest in the minerals in place is framed by *Palmer* v. *Bender*, 287 U.S. 551 (1933), where this Court stated that a taxpayer has such an interest if he "has acquired, by investment, any interest in the oil [or other mineral] in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital" (*id.* at 557). As this Court subsequently explained, *Palmer* sets forth two requirements for demonstrating the existence of an economic interest: the taxpayer must (1) acquire, by investment, an interest in the mineral in place; and (2) look solely to income derived from extraction of the mineral for the return of his investment. *Commissioner* v. *Southwest Exploration Co.*, 350 U.S.

[3] The "economic interest" concept is fundamental in determining the tax consequences of transactions involving mineral properties, and it has other specific applications in this area. For example, depletion deductions under Section 611 of the Code are allowed only to a holder of an economic interest in the mineral property. See *United States* v. *Swank*, 451 U.S. 571, 572, 579-580 (1981). The economic interest concept is also used to determine whether a transaction is a sale or a lease. See *United States* v. *White*, 401 F.2d 610, 613 (10th Cir. 1968) (en banc).

308, 313-314 (1956). See generally Pet. 7-11. Petitioners object only to the application of those established rules of law to the facts of this case. Their contentions are without merit and, if accepted, would permit the use of Section 636 to obtain a windfall tax benefit (in the form of deferral of income actually received) not intended by Congress.[4]

The court of appeals correctly concluded that OG&E did not look to income derived solely from extraction of the gas for the return of any investment and that it therefore failed the second prong of the *Palmer* test (Pet. App. 13a-15a).[5] This Court has stated that it is the taxpayer's " 'possibility of profit' from the use of his rights over pro-

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[4] Section 636 was added to the Code in 1969 to close what was seen as a loophole that permitted owners of mineral properties to secure certain unjustified tax advantages by creating production payments. Under prior law, taxpayers had been able to use production payment transactions to avoid certain limitations on tax benefits – namely, the 50% limitation on taxable income from the property for percentage depletion purposes, the foreign tax credit limitation, the five-year net operating loss carryover limitation, and the seven-year investment credit carryover limitation. Moreover, by using production payments as part of a broader transaction, taxpayers were able to use "pre-tax" dollars to repay what was, in effect, a loan. It was to prevent these abuses that Congress provided in Section 636 that production payment transactions would generally be treated as loan transactions. H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 139-141 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 183-184 (1969); see *Brountas* v. *Commissioner*, 692 F.2d 152, 159-160 (1st Cir. 1982), cert. denied, 462 U.S. 1106 (1983).

[5] Although it discussed the factors relevant to the question whether the first prong of the test was satisfied, the court of appeals ultimately concluded that its analysis led to no clear conclusion on that point, and it expressly declined to decide whether the first prong was satisfied. See Pet. App. 8a-13a. Accordingly, petitioners' argument that the court's discussion of the first prong of the test is inconsistent with this Court's precedent (see Pet. 13-15) is irrelevant and provides no basis for review of the decision below.

duction, 'dependent solely upon the extraction and sale of the oil,' which marks an economic interest in the oil." *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 34-35 (1946) (quoting *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 604 (1946)). As the court of appeals observed (Pet. App. 15a), however, in making the minimum payments required by the "take or pay" contract, OG&E is "not an investor seeking profit from gas production;" it is a purchaser making advance payments for future deliveries of the commodity it purchases. An investor who seeks a return from extraction of gas (*i.e.,* from his interest in the mineral in place) hopes that the production costs he incurs will be less than the price for which the gas can be sold at the wellhead after extraction. OG&E has no such interest in the relationship between production costs and the price at the wellhead. As noted in Judge Williams' dissenting opinion in the Tax Court (*id.* at 45a), the gas purchase contract here provided that OG&E would pay the market price for the gas at the wellhead. Moreover, OG&E would receive no income whatever from any sale of gas by the producers to a third party. OG&E thus is like any other utility that purchases gas from producers; it makes its profits from remarketing the gas to its customers, not from gas production. Since OG&E is not seeking to profit from extraction, the claim that the excess payment created a production payment fails the second prong of the *Palmer* test.

Petitioners contend (Pet. 11-12) that the court of appeals misapplied *Palmer* because the requirement of an "investment" in minerals in place can be satisfied if the "investor" expects a return of capital, even if there is no possibility of a profit from extraction. This Court clearly stated, however, in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. at 34-35, and *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. at 604, that the "possibility of

profit" from extraction marks an economic interest. These cases follow *Palmer* and do not purport to deviate from its rule; hence, there is no reason to ignore these decisions and hold that one who has no expectation of profit from extraction can be viewed as having an economic interest in minerals in place.[6] Moreover, the Court in *Palmer* itself stated that an economic interest requires the acquisition "by investment" of an interest in the mineral. 287 U.S. at 557. The intent to make a profit is inherent in the concept of an "investment." The disposition of money under circumstances in which a mere return of capital with zero profit is the best possible outcome—for example, stuffing one's money into a mattress—is not ordinarily regarded as an "investment." See *SEC* v. *Howey Co.*, 328 U.S. 293, 298-299 (1946) (an "investment contract" for purposes of the securities laws means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party").

The excess payments made by OG&E under the "take or pay" provision are simply one feature of a long-term supply contract. OG&E did not agree to that provision because it wanted to invest in gas in place. Rather, OG&E prepaid for future deliveries in order to maintain good relations with the supplier and a long-term, stable supply of gas. The purpose of a "take or pay" contract, from the purchaser's viewpoint, is to provide flexibility in the event of uneven demand and to maintain stable relationships

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[6] There is no merit to petitioners' argument (Pet. 12) that *Burton-Sutton Oil* and *Kirby Petroleum* are inapposite here because in both cases the question was whether the taxpayer was entitled to depletion deductions. *Palmer* also involved a depletion question. The "economic interest" issue arose in all three cases because depletion deductions are allowed only to a holder of an economic interest in the mineral property, and all three cases are equally applicable here. See note 3, *supra*.

with producers. See Johnson, *Natural Gas Sales Contracts,* 34 Inst. on Oil & Gas L. & Tax'n 83, 111 (1983); Pierce, *Natural Gas Regulation, Deregulation, and Contracts,* 68 Va. L. Rev. 63, 68-69 (1982). A "take or pay" contract also enables a seller to avoid fluctuations in cash flow by assuring a minimum annual return. See *Transcontinental Gas Pipe Line Corp.* v. *State Oil & Gas Board,* 474 U.S. 409, 412 (1986); Johnson, *supra,* 34 Inst. on Oil & Gas L. & Tax'n at 111; 4 H. Williams, *Oil and Gas Law* § 724.5, at 659 (1988). The excess payments were intended to, and did, give OG&E a prepaid contractual right to a supply of gas, not an economic interest in the gas in place.[7]

3. Petitioners contend (Pet. 7-11) that the court of appeals' decision is inconsistent with this Court's decisions in *Helvering* v. *Bankline Oil Co.,* 303 U.S. 362 (1938), and *Paragon Jewel Coal Co.* v. *Commissioner,* 380 U.S. 624 (1965). This contention is without merit. Indeed, *Bankline* strongly supports the decision below, as the court of appeals recognized in stating that "*Bankline* compels reversal [of the Tax Court's decision] here" (Pet. App. 14a).

As the court of appeals explained (Pet. App. 14a), OG&E was in the same posture as the purchaser-taxpayer

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[7] Petitioners err in asserting (Pet. 10) that the Commissioner's position in this case is contrary to his published ruling position. As the Tax Court noted (Pet. App. 34a-36a), Rev. Rul. 80-48, 1980-1 C.B. 99, sets forth the Commissioner's position that a "take or pay" gas purchase contract does not give the purchaser an economic interest in gas in place and, therefore, that Section 636(a) does not operate to exclude from the seller's gross income payments for gas not taken. Petitioners cite (Pet. 10) Rev. Rul. 66-64, 1966-1 C.B. 97, but that ruling merely holds that the purchaser of gas under a "take or pay" contract is not entitled to a current deduction for amounts paid for gas not taken. The ruling does not state or suggest that the purchaser has an economic interest in that gas in place.

in *Bankline.* The taxpayer there was a gas processor that contracted with gas producers to buy wet gas at the well-head, which it then processed into gasoline and dry gas. The Court held that, although the taxpayer "through its contracts obtained an economic advantage from the production of the gas," the taxpayer had "no interest in the gas in place." 303 U.S. at 368. The facts relied upon by the Court in concluding that the taxpayer had no interest in the gas in place are similar to the facts of the instant case (*id.* at 367-368):

> Respondent [the taxpayer] is a processor. It was not engaged in production. Under its contracts with gas producers, respondent was entitled to a delivery of the gas produced at the wells, and to extract gasoline therefrom, and was bound to pay to the producers the stipulated amounts. * * * [T]he gas was to be delivered to respondent at the casingheads or gas traps installed by the producer. Respondent had the right to have the gas delivered, but did not produce it and could not compel its production.

Like the taxpayer in *Bankline Oil,* OG&E was merely a purchaser of gas that had no interest in the gas in place. OG&E's right to offset payments for gas not taken against gas taken in future years was simply a contractual right that gave it an economic advantage from the production of gas.

Petitioners argue (Pet. 8) that this case is distinguishable from *Bankline* and *Paragon* because OG&E bore a risk of loss if the well developed problems and could no longer produce, since the excess payments then could not be recouped. This factual difference, however, plainly does not make the decision below inconsistent with *Bankline* and *Paragon.* Neither of those decisions suggested that risk of loss was determinative of the economic interest question;

indeed, neither decision even discussed risk of loss. Hence, there is no conflict between the decision below and any decision of this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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